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General Business Conditions

THE progress of reconversion during the past month has been disappointing, when contrasted with the hopes which in the weeks after V-J day seemed so well justified. In the industries reports of hindrances and delays in production have been numerous, and the most common reasons are that the labor supply is short, and that strikes have interfered with the supply of the materials and parts which manufacturers need. The coal strikes which extended over four weeks not only reduced the supply of coal, but caused a substantial loss in steel output. This in turn is delaying deliveries of steel scheduled for fabrication into civilian goods. At the same time strikes in various plants making automobile parts have put the automobile industry behind schedule.

The coal strikes were called off by Mr. Lewis October 17, but while they lasted they cost the country some 17 million tons of coal, which cannot be made up because all the coal the mines could produce this year was needed. If steel ingot production had continued at 84 per cent of capacity, the rate reached at the end of September, the output during October would have been one million tons higher, and this also was needed. It is more difficult to measure the loss of automobile production. Considering, however, that the Ford assembly lines were shut down entirely for three weeks and other companies have been delayed, it is reasonable to say that the industry has been put almost a month behind schedule, and the production of passenger cars during the fourth quarter will be substantially less than the 500,000 which the producers previously believed they could turn out.

Another obstacle to expansion of production in some lines is found in existing policies of the Office of Price Administration. Business men have long complained of rigid and unrealistic pricing, and of long delays in obtaining relief. Many of these complaints are supported by a report of a special committee of the House investigating federal agencies, made public during the past month. The report finds that —

> The policy of adherence to rigid formulas has retarded reconversion, prevented production especially in low-priced commodities, has restricted opportunity for full employment . . . It has compelled manufacturers to discontinue and abandon production of prewar low-priced commodities they were skilled in making in great volume, and has permitted newcomers to manufacture such commodities at higher prices than were necessary to enable those already in the field to stay in business.

Hindrances to Production

Losses of production and employment through strikes or slow-downs or oppressive government controls are deplorable, and never more so than at present, when inflation is menacing, demands are almost insatiable, and every possible effort should be devoted to getting goods into the markets quickly. As far as physical difficulties of reconversion are concerned, the industries have made more rapid progress in clearing plants of war work and re-equipping them for peacetime production than most people believed possible. Mr. Krug, the retiring chairman of the War Production Board, in a statement based on a survey as of September 30, said that production programs and goals reported by the reconverting industries had been moved up even higher than those indicated by a previous survey a month earlier. The Federal Reserve Board's index of industrial production for September, which was 172 (1935-39=100) compared with 187 in August and 211 in July, showed increases over August in output of iron and steel, textiles, manufactured foods and tobacco, paper and coal. All these signified expansion of civilian output which partially offset the severe declines in machinery, transportation equipment and other war lines.

This was a gratifying start. In the same statement, however, Mr. Krug was moved to say that the projections revealed by the W.P.B. survey had no meaning in view of the labor situation, and that unless labor difficulties were cleared up in two or three weeks

all expectations would have to be put back. For the month of October the Federal Reserve Board's index will of course reflect the substantial decline in coal and steel output, along with continuing recession in the war industries. It could, and may, recover in November or December if all hands cooperate to get production moving upward. But other strikes, of greater magnitude, are threatened.

The Labor Scarcity

Meanwhile many industries and plants are short of workers, despite the 1,750,000 people recently reported on the unemployment compensation rolls and the demobilization of the armed forces at a rate well above a million a month. In cases where unwillingness of former war workers or veterans to take jobs offered is due to a desire for rest and vacation, and where they can afford it out of their own resources, their choice is a free choice and is not of public concern. Also, the desire of people who have increased their skills and abilities during the war to find jobs where their new skills can be utilized is entitled to sympathetic understanding and generous consideration. They will, and should, take time to look around.

Nevertheless, the productive organization cannot guarantee to all the precise jobs and rates of pay that they might like to have, and the adjustment from war conditions to peacetime work cannot be escaped solely because in some instances it is painful. There was only one buyer of war goods, the needs were compelling, and price was secondary. Wage rates reflected the urgency for production. But in peacetime consumers can and will abstain from buying if prices are too high, production and sales are competitive, and the wage rates which the industries can pay are influenced accordingly. In many instances the character of the work called for has changed completely, and the skills acquired in war work are not in demand to the same degree. The need for shipbuilders is dwindling rapidly, but the textile factories want workers urgently. These changes make adjustments inevitable, and the sooner they are faced the sooner will production and employment rise again.

The delays caused by labor shortage become of even greater public concern when the unwillingness to accept adjustments is supported by compensation payments continuing past the time when jobs are available, and at rates comparable with the wages paid in industry. Many people on the compensation rolls stay there because they want only "suitable" jobs. But the question is, what is "suitable", who should decide, and are the formulas by which the individual decisions are made correct? Or do they obstruct reconversion? Are jobs paying little more than the compensation payments "unsuitable", and if so, what does this imply? There are many jobs, in the service industries and elsewhere, that might not exist at all if the employers were required to pay higher wages.

The C.I.O. has condemned referrals of skilled workers to unskilled jobs paying little if any more than the unemployment compensation, calling it "an abominable system of wage cutting and protection of substandard wages." (C.I.O. News, August 20, 1945.) But although this statement evokes sympathy for workers affected, how representative is it of actual conditions? And where it is representative, is it the whole story? Which is more in the general interest, — to try to maintain for everyone the jobs and wages established in an abnormal time, or to get people to work, increase production and get goods on the market? Over and over again the truth needs to be emphasized that "the test of ability to recover from the war and regain a state of prosperity is in the capacity to produce a flow of goods and supply the wants of the population. There is no other measure of the general welfare than the production, distribution and consumption of goods and services. The problem is obscured by thinking of it in terms of money." The quotation is from this Bank Letter, issue of September, 1945.

It can hardly be doubted that the difficulties of filling up the working force will in due course clear up, as more and more people are released from the armed services, as the time during which workers are entitled to compensation runs out, and as people make the adjustments in attitudes which the situation requires. Meanwhile time is lost, production is held back, and the inflationary forces are permitted to gather momentum, for lack of goods to satisfy demands and absorb accumulated purchasing power.

Wages and Prices

Over all business planning hangs the threat of more and greater strikes unless wage demands are granted. The leaders of the General Motors unions have been authorized by vote of the workers to call a strike, and a vote is to be taken in the steel industry which presumably will have a similar result. A related fear is that a pattern of wage increases may be set, by the larger and richer companies or by low-cost producers, which companies less fortunately situated may be unable to follow without impairing or wiping out profit margins. These fears are increased by uncertainty as to costs and labor efficiency. Controversy and disturbance spread in such an atmosphere.

The policy of the Federal Government, re-stated by President Truman in his radio

address October 30, is to allow, and urge, employers to grant wage increases without government approval, but not to allow such increases to be passed on in higher prices except in certain specified and limited cases. This limits the increases that employers can give. The union leaders express no opposition to this policy. They maintain, however, that the industries can pay the increases they are now demanding — running up to 30 per cent — without raising prices. In the end the claims and counter-claims focus on this allegation.

Amid conflicting statements and contradictory statistics the general reader easily becomes confused as to the merits of the arguments. Some of the facts and figures most commonly quoted, dealing with wartime wages and earnings, have little relevance to the present situation, for the country is now at peace, and all conditions are different. In last analysis current wages must come out of current income. Unless they are equitably related to the price at which the product can be sold production will not go ahead. Hence the critical factor is the level of productivity, costs and profits to be expected, which involves arguing on the basis of assumptions, not now provable.

How Fast Can Productivity Increase?

Thus the unions argue that new methods, techniques and materials developed during the war will be adapted to production of civilian goods and will result in an increase in output per worker well above the average rates of the past. Most people would agree that gains from these factors will indeed be realized. Whether they should be made the basis for further wage increases before they are established, however, is another question. Many manufacturers do not know yet how they are going to absorb the wartime increases. Their wage costs now (average straight-time hourly earnings) are up 45 to 50 per cent over 1939, and in many cases output per man-hour is less than in 1939.* Many of the industries are in a transition and reconversion period. They have not been able to make a practical, large-scale trial of new methods and materials, nor have they obtained all the new and modern machinery they will need. Other industries where reconversion is a lesser problem need new equipment to make good deferred maintenance and obsolescence. For these reasons the gains of technological improvement cannot be realized overnight, but only as reconversion can be completed, high-level activity reached, and new methods brought fully into operation.

Similarly the union supporters argue that labor will be more efficient, — that inefficient workers will be leaving the labor force and replaced by returning veterans and that the reduction in weekly hours to 40 will increase output per hour. Again it will be generally agreed that the labor force will be more efficient, but when and by what margin? What will be the will to work, and the influence on productivity of the unions themselves, with their drive to extend their power and prestige, "featherbedding," and restrictions on individual output?

As for the reduction of hours, the union arguments made little allowance for decreased man-hour output when the increase to the 48-hour week was made. Moreover, the labor statements now generally assume that the reduction in the average hourly wage which is due to the elimination of premiums for overtime, and which amounts to 7.7 per cent in cutting from 48 to 40 hours, is translated completely into a reduction in the cost of the product. But when premium overtime was established it was argued that the premium could be absorbed with little or no increase in cost of the product because it would be largely offset by greater output and spreading overhead expense thinner. The argument cannot be correct both ways.

Another point is that costs will be reduced by reclassification of jobs, or "downgrading," reversing the "upgrading" which took place during the war. Again the question is, how rapidly will this be done and how much will it amount to?

Assumptions on Earnings

Finally, assumptions are made as to earnings before and after taxes. The unions point out that the elimination of the excess profits tax, effective next January 1st, will leave a fund out of which wage increases can be paid. But this again assumes that the volume of business and profit margins will be such that excess profits will be earned. For if they are not earned, the saving will be fictitious and cannot be passed on to anyone.

An estimate of corporation earnings in 1946 is included in a memorandum prepared in the Office of War Mobilization and Reconversion which recently was submitted to the President. According to this estimate, if basic wage rates should be increased by 10 per cent, corporation profits before taxes would be some 30 per cent less than in 1944, but profits after taxes would be greater than in the peak year of the war.

*See reports on productivity and unit labor costs in selected industries, 1939-1944, issued by Bureau of Labor Statistics, May, 1945. Industries in which man-hour output in 1944 was less than in 1939 include the following: cane-sugar refining; canned and cured fish; cement; sawmills; newspaper and periodical printing and publishing; non-ferrous metals smelting and refining; paper and pulp; cotton goods; flour and other grain-mill products.

All the questions above raised suggest the unreliability of such estimates, and the venturesomeness of those who undertake to make them; and the list of the uncertainties can be extended further. What allowance is made for the fact that the civilian lines which will replace war work in many cases are lower-profit items, sold in severe competition? What of the expense of re-constituting and re-training the labor force, due to the withdrawal of people who have worked during the war and the return of veterans? What of reconversion expense, and the high unit cost of low volume production during the reconversion period? Moreover, what will the volume of sales be?

Patience Needed During Transition Period

Much of the current discussion appears to slide easily over both the particular problems of the transition period and the uncertain sales, costs, and productivity of the future. We do not imply that none of these factors can be measured at all in advance, or that the uncertainties apply in all companies and industries, or that forecasts of productivity and unit costs, sales and earnings, are without value. But the question is whether there is a firm basis for deciding at this time what wage increases the industries can pay without raising prices.

President Truman has called on management and labor "to proceed in a peaceful, free and democratic manner", to explore the facts and possibilities through collective bargaining, without greed or unfair dealing. He wisely emphasized that no general formula or percentage of increase can safely be applied, for conditions differ greatly in industries and companies. This is admirable counsel. It takes the responsibility of settlement away from Washington and puts it on labor and management, where it belongs. But when so-called "facts" are subject to all kinds of uncertainties and unpredictable developments, differences are hard to bridge and decisions that are correct in the public interest are hard to reach.

On the other hand, sound conclusions, case by case, could be arrived at by exercising patience and delaying action pending study by management and labor of conditions as they develop. The whole economic situation would benefit if the unions, moving more slowly, allowed the necessary time for the facts to appear and meanwhile devoted their influence and effort to hasten reconversion and expand production. We doubt that union approval for a suggestion of, say, a three to six months' moratorium on controversy would be forthcoming. But plainly it would be beneficial, not only by averting the waste of industrial conflict, but by giving time to determine more accurately what the policy of raising wages without raising prices would allow.

Something of the same thought, but with reverse emphasis, is implicit in section 3 of the executive order issued October 30. This section provides that if a manufacturer grants a wage and salary increase, which is not approved as a basis for an increase in prices, the Price Administrator may review the situation after a test period, generally six months, and determine whether an increase in price ceilings is then required. This is asking manufacturers to accept or risk temporary losses, in the hope that the situation will work out, with a promise of relief if it does not. From the standpoint of the consumer, and of the inflationary danger, it should be noted that the relief would be in the form of higher prices, and not of rescinding the wage increase.

"Ability to Pay"

We lack space to extend the discussion or to repeat what has been said in past issues of this Letter on other aspects of the question. One further point, however, should be made. Demands of labor based on "ability to pay", when pushed to their logical limit, would give to labor all the gains resulting from increases in productivity. Present demands in many cases go to that limit. But if the gains are monopolized by the workers directly concerned, the power of other consumers, who are infinitely more numerous, to buy the product will not be increased. Trade cannot prosper, or the standard of living rise as it has throughout history, unless the gains of higher productivity are diffused. This means not only higher wages for the worker and adequate return for the capital employed, but lower prices for the buyer of the product. If all the gains are given to labor, the end-result will be less employment for labor, for expansion of the market will be obstructed. If earnings that should be plowed back into new capital improvements are diverted into higher wages, technological progress, which requires continuous capital investment, will be blocked. It is a policy of this country to encourage small business, but how can small business grow if labor demands all gains for itself?

Likewise, if wages are to be fixed by ability to pay, there should be recognition of the fact that ability to pay can diminish, when economic conditions change, as well as increase. The formula should work both ways, but the resistance of the unions to giving up advances in wage rates, once obtained, is a factor with which all employers must reckon.

Effects on Prices

In the industries the effect of the pressure for wage increases, against fixed prices for the product, is to weaken the incentive to produce. The higher the proportion which direct labor costs bear to total costs, the more difficult

is the position in which employers find themselves. In due course, as wage increases go around the circle, materials and overhead costs also will be increased. There is a government agency to see that price ceilings are not broken, but none to restrain the demands of labor and decide what wage increases can be borne; nor should there be, for the task of making equitable, practicable and speedy decisions in innumerable cases would be beyond the powers of any agency. But where employers cannot raise wages as much as labor asks, without raising prices, the alternatives are strikes on the one hand or unprofitable operations on the other. Both are equally against the public interest, which demands production.

It is not surprising that opinion is spreading that the price ceilings sooner or later must give. A bulletin of the National Association of Purchasing Agents issued toward the end of the month commented that its members almost without exception were expecting higher prices. "Iron Age" has reported a tendency to stock up among steel buyers, although to be sure this is an inclination that they find difficult to gratify. Unwillingness to sell for delivery very far ahead, unless "escalator clauses" to cover increases in costs and prices are provided, is widely reported. This points to the danger in the outlook, namely, that the "easy" way out, which is the way of inflation, may be taken. Many people may think that "a little inflation" of prices would settle the problem, but history has demonstrated the dangers of "a little inflation". Yet this is the position at which the economy inevitably arrives, when emphasis is on creating money purchasing power, either through government spending or through wage increases which force price increases, rather than on production.

Third Quarter Earnings

Reports issued during the past month by leading industrial corporations reflect for the first time the reversal that occurred after the end of the war in the generally upward trend of sales and earnings. A tabulation of the statements of 320 industrial corporations shows that three out of every five had lower earnings than a year ago.

Total net income of the group, after taxes, and after deduction of deficits by 15 companies, amounted to approximately $244 million, which compares with $278 million in the preceding quarter and is 10 per cent below the $271 million in the third quarter 1944. Although our tabulation for the first half of this year showed a 12 per cent increase over 1944, the third quarter narrowed the gain in cumulative total for the nine months from $779 million to $797 million, or 2 per cent. Exclusive of the 13 oil companies, net income for the third quarter was down 13 per cent, and for the nine months was down 1 per cent.

The reports show a marked divergence between the trends of sales and earnings of the companies that had been engaged largely in the production of war materials and which experienced contract cancellations during the latter part of the quarter, and of those companies in the consumers' goods lines where activity has continued at a high level.

Two out of every three manufacturers reporting sales figures showed decreases as compared with the third quarter 1944, with decreases of 20 to 50 per cent or more in the one group contrasting with increases up to 10 per cent or more in food products, petroleum, building materials, and some other lines. The combined total of sales was down 23 per cent for the third quarter, but only 9 per cent for the first nine months.

Effect of War-End Adjustments

The high wartime tax rates still in effect this year (85½ per cent, net, on excess profits, with an 80 per cent overall ceiling on total federal taxes, including normal and surtax) tend to stabilize net income by offsetting to a large extent the changes in earnings before taxes. At the same time, many of the income statements are greatly distorted by war-end charges and credits. In a number of cases the third quarter reports reveal that a sharp drop in operating earnings, or an actual deficit, was offset by tax credits arising from charge-offs of war plant and equipment, and by adjustment of tax reserves to lower earnings levels.

Tax credits have sometimes been misunderstood or misrepresented as somehow improper or unjustified, and as being "hidden profits" entitling corporations to "huge cash refunds from the Treasury" out of which future wage increases could be paid. Actually, such tax credits reflect merely the adjustment of wartime taxes to real net income over the war period.

The tax law, recognizing the impossibility during the abnormal conditions of the war period of determining exactly the amount of corporate income realized in any one particular year, because of uncertainty as to asset values and costs involved in conversion and reconversion, provides that unused excess profits tax credits may be carried forward for a period of two years, and that a decline in earnings below the excess profits level may be carried back two years and used as basis for a claim for recomputation of prior years' taxes. An actual operating deficit may be carried back two years against normal and surtaxes as well as against excess profits taxes.

This has the effect of averaging or equalizing the taxes relative to real earnings up to a five year period. What it means is taking an-

other loo' at prior years in the light of additional war costs, including reconversion costs now calculable, and adjusting taxes accordingly. It is important to bear in mind that the only way a corporation may enjoy the benefit of a tax refund or credit is to suffer a decline in its earnings, or incur a net deficit.

In the tax bill hearings before the Senate Finance Committee last month, a C.I.O. statement was submitted by Clifford McAvoy calling attention to an estimated increase in corporate earnings to record levels in 1946, the advance in stock market prices since V-J day, the rise in corporate working capital during the war, etc., and asserting:

> Finally, corporations through the carry-back provisions of the wartime revenue acts have their profits guaranteed during reconversion. They will receive refunds from the Treasury if their profits fall below their 1936-39 average. Corporations have accumulated about $30,000,000,000 in carry-back credits with the Treasury, which, in effect, constitute a huge pool of contingent reserves that they can draw upon.

Senator Byrd disputed the witness' statement that corporations had built up a carry-back reserve of $30 billion in the Treasury during the war period. Roy Blough, Assistant to the Secretary of the Treasury and director of the division of tax research, was asked if it were true. Dr. Blough said it was not; that the corporations "were in a position" to demand $30 billion in refunds or tax credits due to carrybacks, "but only if they lost a great deal more than $30 billion through operations during the next year."

Such tax credits do not constitute a "guarantee" of current earnings, but merely a refund for overpayment of taxes during the war period when contingent reserves were not recognized as allowable deductions.

Charge-Off of War Plants

Included in the war-end charges, which many corporations made in the third quarter and which resulted in credits against current tax payments, were charge-offs of the unamortized cost of war plants and equipment. Congress provided in the Revenue Act of 1942 that new plant facilities constructed for war production, and certified by government procurement agencies as necessary to the war effort, were subject to amortization at the rate of 20 per cent annually for a period of five years, or for a shorter period in case the war ended sooner or the facilities were certified by government agencies as no longer necessary. There was no way to tell in advance how much peacetime value, if any, such war plants might have.

With the ending of the war, the unamortized cost of these facilities may be charged off as expense. Some companies made this charge-off in the third quarter and others apparently have deferred the charge to the fourth quarter.

When, as, and if such war plants prove of use to a corporation, the earnings therefrom will of course be subject to income taxes. The depreciation, once charged off in full, cannot be charged again as a deduction from income in computing taxes, and the corresponding tax credits thus cannot be a regularly recurring source from which to pay wages or offset a decline in operating earnings.

NET INCOME OF LEADING CORPORATIONS FOR FIRST NINE MONTHS, 1944-1945

Net Income is Shown After Depreciation, Interest, Taxes, and Other Charges and Reserves, but Before Dividends.—Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

(In Thousands of Dollars)

No. of Cos.	Industrial Groups	Net Income Third Quarter 1945	% Chg.	Net Income Nine Months 1945	% Chg.	Net Worth January 1 1944	Net Worth January 1 1945	Annual Rate of Return % 1944	Annual Rate of Return % 1945
26	Food products	$ 19,283	— 1.2	$ 62,520	+ 6.9	$ 738,983	$ 743,656	10.5	11.2
12	Textiles and apparel	1,816	—12.3	7,804	+ 8.3	121,380	138,197	7.9	7.5
16	Pulp and paper products	5,545	— 1.2	16,660	— 0.9	370,128	378,307	6.1	5.9
35	Chemicals, drugs, etc.	45,106	—14.9	143,668	— 1.6	1,699,988	1,754,698	11.5	10.9
13	Petroleum products	50,348	+ 1.6	159,937	+21.0	1,978,243	2,063,655	8.9	10.3
15	Stone, clay and glass	7,490	—19.4	26,188	— 8.8	394,525	411,189	9.7	8.5
24	Iron and steel	29,081	—17.4	106,545	+ 1.4	2,964,947	2,991,240	4.7	4.7
9	Electrical equipment	18,128	—17.9	60,224	— 3.7	712,191	781,145	11.7	10.3
23	Machinery	4,638	—17.3	18,090	—11.1	223,040	235,621	12.2	10.2
18	Autos and equipment	4,144	—45.2	20,249	—14.7	223,992	240,162	14.1	11.2
52	Other metal products	25,191	—11.0	80,555	— 3.0	1,028,829	1,067,133	10.8	10.1
22	Miscellaneous mfg.	9,990	+ 6.9	28,726	+ 5.9	309,139	332,903	11.7	11.5
265	Total manufacturing	220,760	—10.7	731,166	+ 2.8	10,765,385	11,137,906	8.8	8.8
29	Mining and quarrying	13,204*	—11.1	38,990*	— 5.1	621,097	647,642	8.8	8.0
16	Trade (whol. and retail)	7,220	+10.2	19,541	+13.2	284,979	282,140	8.1	9.2
10	Service	2,641	— 0.9	7,702	— 5.8	141,440	139,971	7.7	7.3
320	Total	$243,825	—10.1	$797,399	+ 2.5	$11,812,901	$12,207,659	8.8	8.7

* Before depletion charges in some cases.

The 320 companies whose published reports are summarized by major industrial groups in the accompanying table are representative mainly of the larger manufacturing organizations in the country, and are not necessarily typical of the smaller corporations, partnerships and individual proprietorships.

The Victory Loan

As we go to press, the country is embarked upon the eighth, and last, of its series of great war loans, with a goal of at least $11 billion. Of this total, the Treasury is asking for $4 billion from individuals, including $2 billion from sales of Series E savings bonds. The balance of $7 billion over and above the individual quota is expected to come from other noncommercial-bank investors. Once more, the commercial banks are debarred from subscribing on their own account (except in limited amounts for investment of savings deposits) in order to limit the inflationary expansion of bank credit.

With a view to cutting down the indirect participation of commercial bank funds, which has been so prominent a feature of previous drives, amounting to 40 to 50 per cent of total sales, the Treasury has introduced additional restrictions.

The decision not to offer an intermediate maturity issue comparable to the 2s of the 6th War Loan, or the 5½ year 1½s of the 7th War Loan, has eliminated any medium-term replacement for investors who might otherwise switch out of such issues purchased before. The Victory Loan offers no marketable security between the 1 year ⅞ per cent certificates and the 14-17 year 2¼ per cent bonds, and unless investors can purchase new medium-term issues in the drive they are more likely to keep those which they have.

Secondly, the new formula limiting insurance company subscriptions to 15 per cent of the company's total holdings of governments as of December 31, 1944, or 6 per cent of total assets on the same date, whichever is greater; and savings institution subscriptions to twice the net increase in assets of the subscriber over the period July 1 through September 30, 1945, plus 7 per cent of the total governments held on June 30, 1945, is expected to discourage undue selling for the purpose of shifting into new issues, with resultant padding of subscriptions and absorption of old issues by the commercial banks.

Thirdly, the ruling by the Treasury limiting war loan deposits in the banks to 30 per cent of all other deposits as of October 31 may prove the most effective way yet devised of checking the practice by some banks of encouraging customers to sell outstanding securities and subscribe to new issues giving rise to war loan deposits in banks handling such subscriptions. With banks having to settle in cash for any subscriptions in excess of those payable in war loan deposit credit, competition for such deposits should be considerably modified.

What the effect of these limitations, together with the end of the war, will be upon total subscriptions to the Victory Loan remains to be seen. In general, it is anticipated that sales will run well above the goal of $11 billion, but fall short of the $26.3 billion actually realized in the 7th War Loan. Chief concern relates to sales of Series E savings bonds, which are expected to call for hard plugging to reach the goal of $2 billion, in view of the reduction in factory payrolls, uncertainties over jobs, and a desire on the part of many people to spend their money for newly available goods. Yet this is the security particularly looked to for reaching the great mass of small income receivers and absorbing excess funds which may otherwise put inflationary pressure upon prices.

It is expected that the Victory Loan will not only make unnecessary any additional open market financing until well after the end of the fiscal year 1946, but might also — depending upon the total amount subscribed — permit some temporary reduction of short-term debt after the drive in the event of tax notes and savings bonds being presented for redemption in excess of sales.

An Obligation to Bondholders

In inaugurating the Victory Loan, Secretary Vinson stressed the anti-inflationary aspect of a successful drive, declaring that it would help give inflation "the knockout punch."

"Putting your money into bonds," he said, "will build a sound economy for the nation that will afford you a prosperous future. As we whipped the enemy overseas, we beat an enemy here at home — inflation."

In urging people to buy war bonds to help prevent inflation, we must not, however, forget our moral obligation to these bondholders to do the other things that are necessary to prevent inflation and maintain the value of these investments. As Secretary Vinson said, "there is one very bad thing about fighting this ogre (inflation): you have to beat him every round." Selling people war bonds — important as that is — cannot do the job alone. The ogre has to be fought on many fronts. There must be adequate taxes and reduction of government spending to shut off the stream of deficit-created dollars that is the main cause of the inflationary menace. There must be production, so that there will be goods in the markets when people come to buy. There must be

attention to costs; for if costs go up because of wage demands or other causes, prices will rise and the bondholders will lose.

There must be, in short, recognition of where the real danger lies and consistency in dealing with it. How can we with logic, candor, or justice tell people they must buy war bonds because *too much* purchasing power is threatening inflation, and at the same time call for injection of *more* purchasing power through government spending and wage increases on the theory that it is needed to avert deflation?

The challenge before us is great, and, as the Secretary says, will be more difficult to meet now that the drama of war is over. It is one, however, that we must meet if we are to keep faith with the millions of people to whom we have sold seven war loans and whose savings are once more being solicited to carry the Victory Loan to success.

Trends in Interest Rates

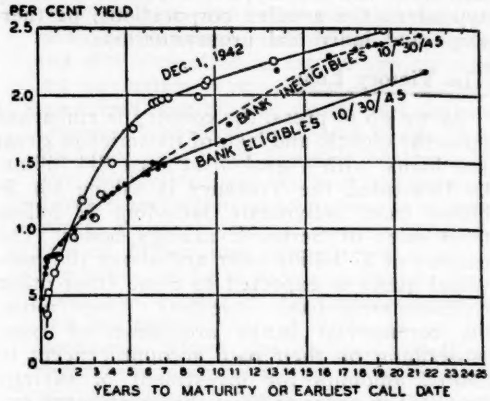
In the period between the 7th and 8th bond drives outstanding Treasury securities continued the trend towards lower yields on intermediate and long-term bonds eligible for purchase by commercial banks. After a temporary reversal on unsubstantiated rumors that the preferential Federal Reserve discount rate of ½ of 1 per cent on loans against short-term governments might be restored partly or wholly to the regular discount level of 1 per cent, prices recovered in August when the terms of the Victory Loan were announced, and have continued generally upward, forcing yields of bank eligible bonds callable in over 5 years to new lows.

The persistent strength in the popular 5-10 year taxable bonds, affecting also the two longer-term bank eligible issues, reflects the continuing influence of government credit and fiscal policies that have been dominant in the market especially over the past year:

(1) The policy of pegging down the short-term interest rates, which has led banks and other investors to reach out for the longer-term higher-yielding issues as confidence has grown in the government's ability to keep interest rates generally from rising.

(2) The policy of restricting the supply of new government issues of intermediate maturity at a time when they were coming increasingly into demand. We refer to the restrictions placed upon subscriptions to the 5½ year 1½s in the 7th War Loan and to the elimination altogether from the Victory Loan of an intermediate maturity within the 10 year term limit eligible for commercial bank holding.

The effect of these policies upon the structure of interest rates is apparent in the accompanying diagram comparing the "curves" of yields of Treasury fully taxable securities of the different maturities at the time of the 1st War Loan in December 1942, and as of October 30, 1945.



Treasury Fully Taxable Securities Eligible and Ineligible for Purchase by Commercial Banks. Yield Curves Dec. 1, 1942 and Oct. 30, 1945 compared.

(Issues outstanding Dec. 1, 1942 all eligible for commercial banks)

What has happened, as banks and other investors have stepped up their bidding for the intermediate-term issues in the face of a diminishing supply in the drives, has been for the yield curve to swing sharply downward on the anchored-down short-term rate end as a pivot. Yields in the 5-10 year category have, as the diagram shows, fallen in this flattening out process to a range of 1.35 to 1.64 per cent (to call dates) at the present time, compared with 1.70 to 2.13 per cent for similar maturities in December 1942, with practically all of this decline having occurred within the past year. At the same time, with the yields on intermediates thus reduced, some bank money has reached out to the two longer-term bank eligible issues now outstanding, driving down the yield on the longest — the 2½s of 1967-72 — to a new record low last month of 2.16 per cent.

Thus far, as will be seen from the diagram, the yields of the long-term Treasury bonds not eligible for commercial bank investment (until within specified periods to maturity) have not been pulled down correspondingly with the yields of the long-term bank eligibles. The yield on the longest-term bank ineligibles is only slightly under 2½ per cent.

The question is, how much further can the bank eligible rates — intermediate and long-term — decline without affecting the bank ineligible rates also. The various classes of investments are not water-tight compartments. Already with the recent further decline in yields of intermediate maturities,

many nonbank investors who customarily seek investment in these areas are taking note of the favorable differentials ruling in the long-term bank ineligible group. Any significant additional decline in rates in the latter group would have important effects throughout the entire interest rate structure, embracing not only governments but other types of investments as well, with adverse consequences upon life insurance companies, savings institutions, and others dependent upon long-term investment income.

In looking ahead to the possible effect of government policies with respect to rates and maturities, it may be noted that the volume of government securities in the intermediate-term classification is — unless replenished by new offerings — due to fall off rapidly with the mere passage of time. Thus, between January 1, 1946, and January 1, 1948, the volume of securities due or callable in 5 to 10 years will — barring new issues — drop from $33 billion to only a little over $10 billion. While the latter figure may hardly seem to spell "scarcity" to many, it can easily prove such in a money market that must be kept constantly supplied with funds so long as inflation of bank credit continues and the Reserve Banks are committed to holding short-term interest rates at their present levels.

All this suggests continuing pressure upon intermediate and long-term rates unless something is done either to make short-term rates more attractive, or to increase the supply of intermediate and long-term issues more in line with the demand. Yet only recently we have been cutting down the volume of intermediate maturities in the drives on the ground that they either caused excessive shifting of other securities to the banks or themselves found lodgment there after the drives, with consequent inflation of bank credit. The fact is that inflation of bank credit is almost inevitable under a rate pattern which offers a constant inducement for banks to borrow from, or sell short-term securities at artificially low rates to, the Federal Reserve Banks while at the same time extending their investments in the longer-term higher-yielding issues.

The offering by the Treasury of long-term bank ineligible 2½s constantly or periodically on tap after the Victory Loan would be definitely helpful in supporting that rate, so important to the savings structure of the country.

Cut in British Interest Rates

The strength of the bond market here was given an added fillip last month by action of the British Treasury in reducing the rate paid to the London Clearing Banks on Treasury Deposit Receipts from 1⅛ to ⅝ of 1 per cent. These Receipts, representing in effect 6 months loans to the British Treasury, now constitute some 40 per cent of the assets of the Clearing Banks. Although non-negotiable, they may be tendered at par in payment for subscriptions to British Treasury bonds; and lending banks in an emergency may require repayment before due date, but subject to a rebate at Bank rate now 2 per cent.

Accompanying this action, rates for 3 months British Treasury bills dropped from 1 to ½ of 1 per cent, while the Clearing Banks reduced rates paid on deposits from ½ of 1 per cent to zero on current accounts and from 1 to ½ of 1 per cent on time accounts (originally 7 days but now extended to 14).

The move represents a step in the Labor Party's easy money program, foreshadowed in the Chancellor of the Exchequer's remarks in September urging Britons to buy bonds during the saving campaign then starting because "it may well be that in the future the rates of interest on new government securities will be lower." While stressing the importance of savings, and declaring that "a large part of the national income must be saved if an efficient British industry is to be rebuilt," the Chancellor nevertheless went on to say that a study of the possibility of cheaper money and lower rates of interest was under way. How far Britain intends to carry this policy of lower rates into the longer maturities of government securities is not clear, but the question arises whether penalizing the saver is exactly the best way of getting more people to save. Looking ahead to the time when funds again move freely, lower rates will make the London market less attractive to foreign money.

Any speculation as to the implications here of the British rate reduction ought to take account of the fact that British interest rates have been, and still are in most cases, above our own. Thus our Treasury bill rate of ⅜ compares with the British bill rate of 1 per cent formerly, and ½ now. There is no precise counterpart of Treasury Deposit Receipts in this market. As to the longer maturities, the British War Loan 3½s callable in 1952 are selling on a 2.96 basis, with 2½ per cent National War Bonds of 1952-54 quoted a shade over par, compared with a yield of less than 1½ per cent for U. S. Treasury issues of comparable call date.

U. S. Savings Bond Redemptions

In many quarters apprehension has been expressed that the end of the war might be followed by a rush to redeem a large proportion of the $46.7 billion United States Savings bonds outstanding, thus aggravating the inflation danger while goods are still scarce and

burdening the Treasury with heavy demands for funds in addition to its current requirements. People remember that after World War I many Liberty bonds were thrown on the market with so little regard for what they would bring as to drive them at one time in 1920 to an 18 per cent discount. Of course, no real analogy can be drawn because the present savings bonds may be redeemed at cost plus accrued interest — the $33 billion of Series A to E on demand and Series F and G on one month's notice — but it is a matter of concern to everyone that the good effects of wartime saving should not be undone.

However, the figures to date indicate that redemptions of savings bonds, while substantially higher than last year or earlier in 1945, were little affected by V-E day and have not reached alarming proportions even since V-J day. Redemptions of all U. S. Savings bonds reached a peak of $464 million in the tax month of March 1945. Lower figures were reported for each of the next four months, followed by a rise to $531 million in August, $528 million in September, and $616 million in October.

September was the first month to show an excess of redemptions over sales, which were $514 million, but a slight gain in amount outstanding was reported, after crediting $41 million accrued discount (increase in redemption value of outstanding bonds). In October, which included three days of the Victory Loan, sales exceeded redemptions by $8 million.

Because sales are so large during drives and relatively low between drives, a better measure of the significance of redemptions is their relation to the amount of bonds outstanding. Since Pearl Harbor, redemptions of savings bonds have risen from an annual rate of 3 per cent of the amount outstanding, in late 1941 and in 1942, to 11 per cent in January-July 1945, to 14 per cent in August, 14 per cent in September and 16 per cent per annum in October.

Although each form of saving is influenced by factors peculiar to itself, it is interesting to note that turnover of savings bonds compares favorably in proportion with that of savings deposits, although the comparison with life insurance is less favorable. Withdrawals of deposits from members of the Savings Bank Association of the State of New York have decreased from 26 per cent of amount on deposit in 1941 to a 21 per cent rate in the past year, and about the same so far in 1945. Payments by life insurance companies on account of lapses, surrenders, etc., according to the Institute of Life Insurance, have decreased from nearly 20 per cent of the total reserve against insurance and annuity policies and contracts outstanding in 1941 to about 6 per cent in 1944 and 1945. Policy loans have diminished steadily month by month. So far the only perceptible effect of war contract cancellations on life insurance has been a sharp decrease in sales in August, especially group policies, but September held up well.

The British also achieved wide distribution of savings bonds, called National Savings Certificates, during the war. These Certificates, like our Series E bonds, pay no interest currently but accumulate it until maturity (also 10 years) at 3.17 per cent per annum (compared to 2.90 per cent for Series E) for the fully taxable series and 1.41 per cent for the tax exempt issue. Likewise they are non-negotiable but cashable at stated advances over the purchase price at stated intervals, and are available in small denominations, with restrictions on the amount which may be held. Redemptions of British War Savings Certificates, on an annual basis, rose from about 4 per cent of the amount outstanding in 1943 (compared to 7½ per cent for U. S. Savings Bonds) to nearly 5 per cent in 1944, 5½ per cent in the first eight months of 1945, and 8 per cent in September 1945. Roughly, then, the British small saver has been only about half as ready to cash in his war savings as the American, but in each case the rate of redemption is half again as high since the end of the war. The higher rate of redemption in the United States may be due in part to the volume of bonds sold on payroll deduction plans, which the British have not used.

As in the past, redemptions of F and G bonds, purchased largely by corporations, banks (for trust funds) and religious, philanthropic and educational institutions, are much lower than for Series E, which may be held only by individuals, and the smallest denominations show the highest rate of redemption.

Average Man's Position Improved

In trying to foresee the probable scale of redemptions over the near future, various conflicting influences appear. Most important, perhaps, is the fact that people as a whole are better off financially than ever before. In the past quarter century per capita savings and other time deposits have more than doubled, demand deposits and life insurance in force have each trebled, and currency in circulation quadrupled. Individual liquid assets, including only currency, deposits and government securities, are now estimated at approximately $1,000 per capita or nearly $4,000 per family, to which should be added life insurance with a face value of another $4,000 per family and with a present asset value of about $1,000. Personal debt has diminished during the war to the lowest point in years. All told, the average family is now worth probably at least

three times as much as the previous generation, in liquid resources.

On the other hand, two important factors will tend to increase redemptions from now on. Although employment may increase, unemployment also will probably rise for a while since reemployment can hardly keep pace with the rate of return of men from military to civil life. While loss of pay is cushioned by tax-exempt unemployment compensation, will the unemployed worker draw on his savings to maintain his "standard of living" or will he cut expenditures to fit his reduced income? If he uses up savings, in what order will he draw on cash, deposits, war bonds and insurance?

As to the great majority, who remain employed, will they hold their bonds because they want the security of personal savings, or will they cash them and spend the proceeds because, on the contrary, they feel security by reason of having a job, with unemployment compensation and old age pensions to fall back on?

Survey of Liquid Resources

People have been endeavoring to amass facts upon which to base an opinion on these questions, and the correct answers are of great interest to those who have goods to sell, to government policy makers, and to financial institutions. Because of the importance of learning more about the holders of liquid assets and their attitudes toward their holdings, the Board of Governors of the Federal Reserve System requested the Bureau of Agricultural Economics to conduct two experimental surveys. The results of these surveys, made in January and February 1945 in Birmingham, Alabama and Douglas County, Illinois, are described in the September Federal Reserve Bulletin.

Perhaps the most significant conclusion drawn by the Board, subject to qualifications relating chiefly to the scope of the survey, is "that the desire for economic security and advancement has been the most important incentive leading to the accumulation of liquid assets." The "security" purposes most stressed were for hard times, "rainy days," old age, emergencies and children's education, while "advancement" meant chiefly the purchase of permanent assets — farm, farm equipment or home for farmers, and home in the case of nonfarm families. Farmers also saved to repay mortgage debt. These traditional objectives of saving were cited as their prime motives by 85 to 90 per cent of the respondents, only about 10 per cent admitting saving for current expenditure. Whereas 60 to 75 per cent of those replying expressed willingness to cash war bonds to buy permanent assets, only 20 per cent would use them for the purchase of "durable goods" and 11 to 15 per cent for "luxuries."

To the extent, then, that these replies are representative and in so far as people live up to their worthy intentions, it would appear that holdings of war savings bonds are destined in comparatively small part for readily consumable goods, but rather for permanent assets such as farms and homes. They may, however, constitute a cushion against possible deflation in case of widespread unemployment or depression.

After World War I the peak of war bond liquidation came more than a year after the Armistice, and bank holdings of governments rose most sharply in 1922. This time some increase in redemptions is to be expected from now on in any case, because the figures include the automatic redemption at maturity of the earliest issues, which began maturing in March 1945. But these redemptions at maturity are a minor factor, the total due in the next 3¼ years being only 2.8 per cent of all savings bonds now outstanding.

Importance of the Victory Drive

During the 8th War Loan drive, the ratio of redemptions to sales is naturally decreasing. Experience of previous drives indicates that redemptions decline absolutely as well as relatively during the drive, though they may rise beginning 60 days afterward (the earliest date redemption is permitted) to the extent of the overbuying and overselling that inevitably accompany the enthusiasm of the drive. Savings bond investors should be aware of the advantage of holding the bonds as long as possible, bearing in mind that the interest yield is graduated. No interest at all is earned if an E bond is redeemed in the first year, while the rate earned on bonds redeemed between 1 and 2½ years after purchase compares roughly with the market rate for such maturities. For bonds held over 2½ years the yield is much higher than on market issues, but the full 2.90 per cent compound annual rate accrues only if the bond is held the entire 10 years to maturity.

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